Corporate Governance

What is Corporate Governance

Corporate governance is the system of rules, practices and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

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BREAKING DOWN Corporate Governance

Governance refers specifically to the set of rules, controls, policies and resolutions put in place to dictate corporate behavior. Proxy advisors and shareholders are important stakeholders who indirectly affect governance, but these are not examples of governance itself. The board of directors is pivotal in governance, and it can have major ramifications for equity valuation.

Communicating a firm's corporate governance is a key component of community and investor relations. On Apple's investor relations site, for example, the firm outlines its leadership and governance, including its executive team, its board of directors and also the firm's committee charters and governance documents, such as bylaws, stock ownership guidelines and Apple's articles of incorporation.

Corporate Governance and the Board of Directors

The board of directors is the primary direct stakeholder influencing corporate governance. Directors are elected by shareholders or appointed by other board members, and they represent shareholders of the company. The board is tasked with making important decisions, such as corporate officer appointments, executive compensation and dividend policy. In some instances, board obligations stretch beyond financial optimization, when shareholder resolutions call for certain social or environmental concerns to be prioritized.

Boards are often made up of of inside and independent members. Insiders are major shareholders, founders and executives. Independent directors do not share the ties of the insiders, but they are chosen because of their experience managing or directing other large companies. Independents are considered helpful for governance because they dilute the concentration of power and help align shareholder interest with those of the insiders.

Good and Bad Governance

Bad corporate governance can cast doubt on a company's reliability, integrity or obligation to shareholders — which can have implications on the firm's financial health. Tolerance or support of illegal activities can create scandals like the one that rocked Volkswagen AG in 2015, when it was revealed that the firm had rigged engine emissions tests in America and Europe. Volkswagen saw its stock shed nearly half its value in the days following the start of the scandal, and its global sales in the first full month following the news fell 4.5%.

Companies that do not cooperate sufficiently with auditors or do not select auditors with the appropriate scale can publish spurious or noncompliant financial results. Bad executive compensation packages fail to create optimal incentive for corporate officers. Poorly structured boards make it too difficult for shareholders to oust ineffective incumbents. Corporate governance became a pressing issue following the 2002 introduction of the Sarbanes-Oxley Act in the United States, which was ushered in to restore public confidence in companies and markets after accounting fraud bankrupted high-profile companies such as Enron and WorldCom.

Good corporate governance creates a transparent set of rules and controls in which shareholders, directors and officers have aligned incentives. Most companies strive to have a high level of corporate governance. For many shareholders, it is not enough for a company to merely be profitable; it also needs to demonstrate good corporate citizenship through environmental awareness, ethical behavior and sound corporate governance practices.